

Economic Policy Review

October 2007

© IME www.ime.bg/en

In the issue:

The currency board is the most suitable money restriction until the acceptance of the EURO**The Latest News On the Teachers Strike****Belene for Ever!****From the European Commission to the Bulgarian notaries****Security, freedom and investments. A look at the UNCTAD report****Rumors worthy of Nobel Price****Theory of Political Games****IME NEWS****Support IME**

The currency board is the most suitable money restriction until the acceptance of the EURO

Dimitar Chobanov

Recently people started talking again about the currency board. This time around the discussion was started not by Bulgarian analysts but foreign experts. In their opinion representatives of the European Central Bank claim, that the countries which have accepted the currency board will have problems to maintain good results over sufficiently long time. They face the challenge to be stable in the process of convergence to the average levels of income in the European Union.

The key aspects of economic freedom are several – voluntary exchange, low taxes and prudent fiscal policy, protection of property right, stable currency, limited interference of the state with the economy, free movement of capitals, market definition of wages and prices. In Bulgaria the way to achieve stability of the currency was through the introduction of the currency board. The meaning of the board is that the Bulgarian Central Bank is strongly restricted to lead an independent monetary policy. The Bulgarian lev is linked to the euro by a strictly defined exchange rate, assuming that this anchor will insure low levels of inflation. The Bulgarian National Bank does not control the interest rates in the country (it announces the base interest rate, but does not determine it), does not perform

open market operations (purchases and sales of government bonds for its own account), as it does not have the right to credit the government under any form; does not buy discounted policies from commercial banks, thus providing credits to the commercial bank only in case of systematic liquidity crisis and then it is guaranteed by marketed securities. The only instrument of monetary policy, which BNB is allowed to use is the minimum required reserves. The aim is however that the level of these minimal required reserves should reach the average levels in the EU – approximately 2% of depository base.

All measures mentioned above are aimed at applying strict budgetary restrictions on the entire country, which leads to the necessity the government to maintain close to balanced budgets. This refers to the private sector as well – commercial banks could not expect from the central bank to save them if they carry unwise policies. They must limit the risk in their operations which they perform – for example crediting. The situation is identical in the real sector – the repetition of the situation from 1996-7 is not possible. At that time the loss making state companies were accumulating debts, which at the end of the day were covered by local currency emissions. The moral hazard was extremely high, since the managers of these companies and of the entire public sector knew that the expenditures which they make will afterwards be covered. Thus we got an

uncontrolled increase of borrowing. The decision of the government at that time was to devalue the currency in order to reduce the real value of those debts. This however meant, that the creditors (in that case almost the entire population) lost by the devaluation of the lev, while the wealth was redistributed towards the borrowers but in addition the uncertainty increased and real incomes were reduced.

All of this resulted from the unstable currency. The currency board stabilized the lev against the euro (initially against the German Mark) and hence against the main global currencies. The Board reduced the inflationary expectations in the country, since specifically the exchange rate was used as the “price” of the money during the crisis. The economy was gradually stabilized, the confidence in the lev increased, the level of substitution of the local currency by foreign currency was reduced and the real incomes began to increase. Naturally the stable lev is not the only reason for the positive developments. Very significant is the effect from withdrawal of the government from the economy through privatization and the reduced control of wages and prices, liberalization of capitals, reduced obstacles to international trade. The currency board however represents one of the fastest and complete reforms which results are easy to note. The reduction of the inflation rate after 1997 is drastic compared to the one before that. The financial stability significantly increases the possibilities for effective direction of the savings into productive investments, which at the end increase the economic growth.

Naturally, the currency board has its opponents, which claim that the higher inflation rates in the country lead to overvaluing of the lev as compared to the fixed exchange rate. These statements however are unfounded and represent an arbitrary claim. In this case it is necessary to differentiate between two different concepts. The real appreciation of the lev is a result of the inflationary differential with the main commercial partners. The over valuation, however is linked to the comparison between the current exchange rate and the equilibrium exchange rate defined by the fundamental factors. Only such a comparison could show whether or not the lev is overvalued. To this aim it is necessary to develop a model with which to find the equilibrium value of the lev. The factors

which determine the equilibrium rate are the terms for trade (i.e. the relative prices between the exported and imported goods), the gross savings and the foreign direct investments. Their interactions lead to the increase of the equilibrium rate. The results from the model are shown on Figures 1 and 2, which represent the short term and medium term differences between the current value of the lev and the equilibrium determined by the fundamental factors. Along the Y axis is the difference in percentages, while along the X axis is the respective quarter. As a whole the difference between the real value and the calculated value is within the range of ± 4 per cent during the period between the introduction of the currency board and the first quarter of 2007. Hence, it is not appropriate to state that the lev is over valued, which means that the fixed exchange rate must be kept at the current level. Besides that, the conversion after the euro becomes the official means of payment must be done at that rate.

Figure 1: Short term misalignment (between the current REER and estimated equilibrium REER)

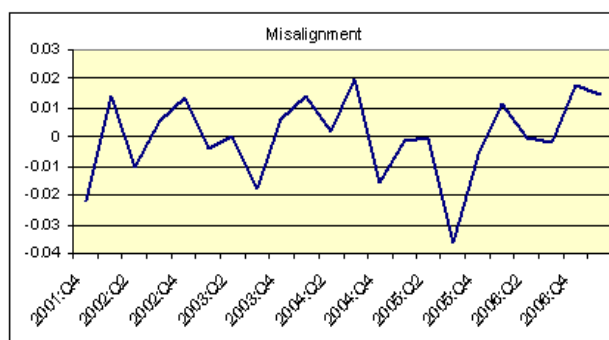
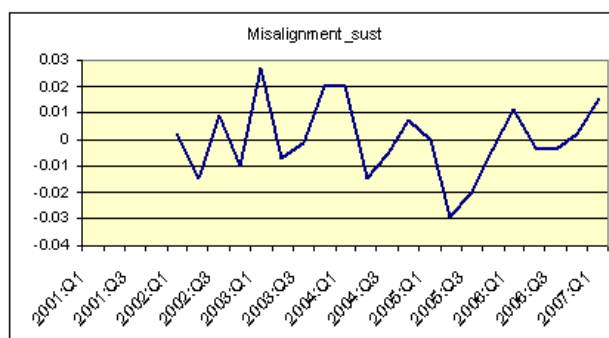


Figure 2: Sustainable misalignment (between the current REER and estimated medium term equilibrium REER)



The Latest News On the Teachers Strike

Adriana Mladenova

The good news

The subject about which the parties agreed during this week is the decentralization of the system of school and pre-school education and moving towards delegated budgets, where the schools become secondary level managers of the budgetary credits. Minister Valchev promised publicly that if he is the minister of education until the end of the school year there will be matriculation. Since for years the introduction of matriculation exams has been postponed for various reasons, which is delaying the development of the educational system in the country.

The bad news

In public discussion minister Oresharski stated that if the salaries of the teachers are increased by more than 70% under pressure and with public support, this is a clear indication that the society agrees to tax increase. Because in the current macro-frame, which is being prepared, there is no possibility to satisfy the requirements of the trade unions, without changes in the income part of the budget. Such development would be bad, since Bulgaria is moving in the right direction – reduction of the tax and social payments burden, facilitation of tax payments, more “market” and less “state”. To lead such a policy, however, a clear public support and approval are required, which had not been observed in the last few months. More and more groups are making requests to the government not for more freedom and autonomy but for higher wages and larger share from the budget.

While more money in the public sector distributed without any discretion means greater redistribution in the economy, as the state does not create value, it has to take it from somebody to give it to someone else.

Actually, delegated budgets, decentralization and autonomy of the schools are equal to higher wages for the people working in the system, since it will start functioning more efficiently and justly. However, by how much the wages of the teachers will be raised would depend on the skills of the headmasters to manage the schools, from the motivation of the teachers and the quality of education they offer. Without competition and market it is impossible to have a just valuation of labor in any sector, including the education.

The teachers representatives, however, require specific amounts and firm promises for percentage increases of wages, here and now, and to have for everybody. For many years the state has been the only employer in this sector, which creates a culture of dependence and channels the thinking in a direction that it is the state's obligation to take care and ensure good quality of life and that is not a personal responsibility.

The truth is that the government could not increase drastically the wages in the public sector without this having a negative effect on the economy. The same as printing money does not mean enrichment of the population and the increase of the minimal wage does not fight poverty. Those people have higher standard of living, which live in countries managed by the market principals: freedom of choice, personal responsibility and voluntary cooperation between people.

Belene for Ever!

Krassen Stanchev

What are the conclusions from the developments in the negotiations about the building of NPP Belene during this week?

Very simple – the project is clearly becoming a lost cause and the negative forecasts of the skeptics are being proven or exceeded

The balance

For details everybody can look through the papers.

The more general picture consists of the following:

- A bit over 2% of the GDP will be the state warranty – for the time being,
- Only 1/16 of the expected costs will be financed by syndicated loan,

- The actual financing will be with state warranties, loans and contract for purchase of the electric energy from the new power plant,
- There are disagreements with the leading the tender Russian company with reference the evaluation of “the old equipment and activities”.

Translated into more common language this means:

- The private sector believes that not more than 6-7 per cent of the activities and the deliveries for “Belene” could be banked;
- The participants in the tender are motivated mainly by the state warranties;
- The ambiguities about the activities will continue regardless of the decisions at this stage and this will continue to increase the cost of the project and probably will take more time;
- The National Electric Company (NEC) is something like a mail box through which pass the contracts of the participants in the construction of the power plant in order to become burden for the finances and respectively the tax payers for the lifetime of about one generation;
- NEC undertakes the indeterminateness and the risks in regional electricity market, but the dividends of the participants in the consortium look certain.

Political sense

In the language of political developments during this week could also be clearly formulated. We are talking about:

- Without clear obligations Russian and connected with Russian companies firms got preferences to build a nuclear power plant on Bulgarian soil at a riskier and more expensive place than the alternative places for construction of new nuclear capacity,
- The old Soviet idea for Bulgarian-Soviet industrial undertakings, financed with loans from western banks, which the Bulgarian people have to pay, is now implemented by state companies of the Russian Federation, but without

significant changes in the mechanism: the work of these companies is paid by the Bulgarian taxpayers;

- This scheme was implemented with the efforts of two Governments, which intentionally manipulated public opinion and succeeded to put to sleep the vigilance of Bulgarian society with the aid of the President and his advisers, “brain trusts” such as Bulgarian academy of Sciences, one economic centre and others.

Deliberate fallacy

Was it possible to foresee these developments?

Categorically “YES”. It is sufficient to see the publications referring to the subject of NPP “Belene” in this bulletin and the development of the arguments of IME in the press, as well as the publications of Georgi Kaschiev. Practically the general direction of what is happening was apparent since February 2002 when the Prime minister of Bulgaria undertook the obligations in front of the Greek Prime minister related to NPP “Kozloduy”.

The deliberate fallacy of public opinion by the last two Governments, and primarily by the Ministers of energy passed through several stages:

- First, an attempt was made to show that the project is profitable and would be financed by future sales of electric energy;
- Second, when the above arguments were proven faulty a thesis was presented that under no circumstances the new nuclear power plant would be finance through state warranties and contracts for sale of the energy from it; apparently thanks to these arguments a green light was give to the procedure to start the negotiations;
- Third, the list of companies and banks willing to participate became wider than only Russian and their subsidiaries (since their analysis indicated that in the end the government is going to pay);
- Fourth, when now it became apparent that it is not true and there would be no warranties and contracts to purchase of electric energy, began a period of simple breakdown of the financing into fiscal years, which will be accompanied by planning of the claims by the

construction companies of the “Belene” project by fiscal years.

In the bottom for the success of this tactics of changing the rules of the game during the game

stands one conscious self-delusion that the Bulgarian Government could not be insolent and that in the basis of its activities are good intentions in the interest of the people.

From the European Commission to the Bulgarian notaries

Svetla Kostadinova

The fact that the European Commission (EC) performs reviews of the achievements in Bulgaria and imposes sanctions could prove to be a good policy. Since our society, including the Parliament, could not exercise effective control over the Government, it is as well that there is an external factor.

The probability the country will be sanctioned due to the still existing requirement that the qualified notaries must have a Bulgarian citizenship is real. What is important is that most probably Bulgaria will have to remove this restriction, but it is only one of many, which exists. In addition of citizenship we are talking about fixed prices, mandatory membership and fees to the Notary Chamber, geographic limitations and minimal experience. All these in the last few years is viewed by the EC as a clearly proven obstacle before the development

of many professions from one point of view and from another – obstacle to the economy and the users of those services. In addition to the notaries, this applies to a greater degree for the auditors, pharmacists, architects and engineers.

As it could be seen from the table below, apparently the EC will have a lot of work in subsequent years. It will be interesting to follow the debate in society, since up till now the reverse process was trough – most of the restrictions have been introduced in the last 4-5 years as arguments “protection of the public interest”, “protection of quality”, “protection of the end users” and “protection of non loyal competition”. It is important to know that the EC is determined to remove these restrictions and the European Parliament last year supported this policy. Another important thing is that there are practical examples of countries, which on their own have a low degree of regulation of these fields – Great Britain, Denmark, Holland, Ireland, Finland where the effect is competition, choice and low prices. In other words there is nothing to worry about!

Regulation of selected fields in Bulgaria

Lawyer	Engineer	Pharmacist	Notary	Accounting, Auditing	Architect
<ul style="list-style-type: none"> - Practice - Minimal Prices - Mandatory membership of the bar association - Recommended Prices - Advertising is not allowed 	<ul style="list-style-type: none"> - Mandatory membership in the chamber - Mandatory practice - Minimal prices - Registration of the contracts 	<ul style="list-style-type: none"> - Mandatory membership in the Union - Practice - Mandatory pharmaceutical education in order to own a pharmacy - A pharmacist could open only one pharmacy and is mandated to work there - The pharmacist could not be simultaneously a owner and distributor 	<ul style="list-style-type: none"> - Requirement about the number of notaries per certain number of people - Lifetime right to practice the profession - Fixed prices - Advertising is not allowed - mandatory minimal practice - Mandatory membership in the chamber - Mandatory Bulgarian citizenship 	<ul style="list-style-type: none"> - Minimal prices - Mandatory membership in IDES - Partial limitations on advertising - Limited public information - Mandatory practice 	<ul style="list-style-type: none"> - Mandatory membership in a Chamber - Mandatory practice - The designers should not be ownerd of construction companies - Minimal prices - Registration of the contracts for design

Source: „The degree of regulation of the free professions in the European Union” a research of the Institute for market Economics, June 2007

Security, freedom and investments. A look at the UNCTAD report

Metody V. Metodiev

Recently was published the report by UNACD which revue the investments on a global scale.

For a third consecutive year the flow of direct foreign investments (DFI) on a global scale for 2006 increased by 38% and have reached 1 306 billion dollars. The growth of DFI can be observed in all three basic groups of countries: developed, developing and the countries in transition. The increase of DFI is partially caused by the high corporate profits, which reflects in the prices of the stocks on the World markets. Another fundamental factor is the realization of mergers and buyouts, which is implemented by a large number of DFI's in the countries. The large corporate profits and the reinvestment of part of them in buying stocks abroad are a significant component of DFI in the various countries.

The report notes the positive trend of the government policies around the World, which are aimed at optimizing the regulatory environment for doing business. On a global scale, 147 changes have been made in the policies of the countries, during 2006, which intend to improve the environment for doing business. Approximately 74% of those are made in the developing countries. Some of the main directions of the governments work had been towards the reduction of corporate taxes and greater liberalization of various sectors of the economies.

The direct foreign investments in the region of Southeast Europe have increased with 68% and have reached 69 billion dollars. Bulgaria is among the five countries (Russia, Romania, Kazakhstan, the Ukraine and Bulgaria) in the region which have attracted most DFI. These countries accumulate 82% of the total investments in the region.

On the World investment map Bulgaria (for the period 2004 – 2006) had reached the prestigious seventh place in attracted investments as a percentage of the GNP.

The policies implemented and more accurately the signals which they send to the foreign investors are a decisive factor for the investor to choose a given country or not.

Positive signals:

- **Macroeconomic stability** expressed in: stable currency, low inflation, observing the undertaken obligations; leading a fiscal policy which is orientated forwards the possible reduction of spending in the public sector, lower tax burden, lower level of redistribution through the state of the income created by the real sector; at cetera;
- **Political stability;**
- **Foreseeable policies;**
- **Confidence in the policies;**
- **Carrying out of (competitive) reform policies:** competitive policies in the area of education, effective state administration, competitive tax policy, effective judiciary system, clear and simple rules for conducting business. In general the government must implement such policies which will help to increase the competitive advantage of the country;
- **Stable banking system and developed financial markets;**

Negative signals could be, in general, expressed by loss of confidence by the foreign investor of the policies implemented by the state. They could be expressed in swift changes in fiscal policy (from restrictive to expansion or vice versa) of the country, (which will affect the labor market, the price levels of the banking and financial sectors, the competitiveness, currency stability and the like) the lack of transparency in the policies by the government and degrading of the conditions for doing business.

Rumors worthy of Nobel Price

Peter Ganev

The former US vice president Al Gore and the Intergovernmental Panel for Climate Change with the UN received the Nobel Peace Prize for 2007. Gore received the prize for his movie "The Inconvenient truth", which is focused on the changes of the World climate and the possible influence of human activities on it. The Intergovernmental panel for Climate Change (IPCC) was awarded the prize for its research on the role of human activities as factor of global warming. IPCC was founded in 1988 and includes 2 500 scientists from over 130 countries. This year the Panel issued a report which throws some light on most of the significant changes in the World's climate.

The movies "The Inconvenient truth" and the above mentioned report of IPCC are the bases of all claims about the negative effect of humane activities on the climate. The enormous public outcry and the governments' interest with the problem made the climate changes the top priority of mankind together with the fight against poverty. What is happening if however everything said in Al Gore's movie is one-sided and actually does not represent the truth, while in the IPCC report there is not a single proof of a relation between human activities and climate changes?!

„The Inconvenient Truth“?

Only a few days ago a judge from the superior court of the UK ruled that Al Gore's movie is exceptionally one-sided, exaggerated and aiming at the dissemination of alarming unconfirmed rumors. The ground for judge Burton's decision became the idea to distribute and show the movie in the schools in order to achieve better understanding of the problem. This idea provoked the father of two children, who in his efforts to protect them from "brain washing", reached to the Superior Court.

In judge Burton's decision are discussed nine fundamental claims of Al Gore which are absolutely unproven or clearly wrong. After Al Gore's claims are the arguments of the judge:

1) *"The raising of the sea level by 20 feet will be caused very soon by melting of ice sheets"* – for the raising of the sea level would be required thousands of years;

2) *"The low corral islands in the Pacific Ocean had vanished"* – there are no proofs supporting this claim;

3) *"The Gulf stream, which is warming up the Atlantic Ocean will suddenly stop"* – the probability of this event in the near future is minimal;

4) *"The graphics showing "strong relation" between the increase in emissions of carbon dioxide and the increase of the temperature for a period of 650 000 years"* – although such relation between the two exists, it does not prove Al Gore's claims;

5) *"The disappearance of the snow from Kilimanjaro results from the global warming"* – there are not scientific proofs, which will support the thesis that the disappearance of the snow is a result from human activities;

6) *"The drying up of the Chad lake is one of the best examples for the catastrophic consequences from the global warming"* – the reasons for the drying up are not found yet;

7) *"The Katrina hurricane was caused by the global warming"* – there are no proofs supporting this claim;

8) *"The Polar Bares are dying out (drowning) as they have to swim 60 miles in order to find ice"* – recently only four polar bears had been found drowned and it was due to a storm;

9) *The corral riffs lose color due to the global warming* – the factors are many (mentioned by Al Gore in the movie) and it is difficult to define the influence of each one.

The report of climate change?

The report on climate change of IPCC does not provide a causal relation between human activities and the global warming. The most extreme claim in the report states only "it is possible that". Let us see the connection, indicated in the report, between five fundamental phenomena (caused by climate change) and human activities:

- 1) *"More and more warm days and nights, respectively less cold days in different regions in the World"* – possibly caused by mankind;
- 2) *"More frequent very hot days"* – it is possibly caused by mankind;
- 3) *"Drought"* – more likely yes, than not;
- 4) *"More tropical storms"* – more likely yes, than not;
- 5) *"The raising of the sea level"* – more likely yes, than not.

The authoritative report in defense of the theory of global warming caused by human activities

reaches the authoritative conclusions "it is possible"! The same could be said by any man on the street. To put a blind faith in such a claim and a movie with high artistic value and practically zero scientific proofs is simply insane. Pressing the view that there is a consensus in the scientific community on this topic is complete fallacy. Actually from 528 reports about the climate change, only in 38% of them the link between human activities and global warming is mentioned. The climate change and the factors, which cause them, are not facts, which are simply registered, but an open discussion, which in the future will throw more light on this issue.

Theory of Political Games

Metodi Lazarov

You have probably seen the movie "Beautiful Mind", which won the Academy award for best production in 2001. The story is about the life of the American mathematician John Forbs Nash, who is best known with his proofs of the so called "Nash's equilibrium." Briefly, the equilibrium proves that there is a balancing distribution of two or more strategies between the same numbers of players, where any action by one of the players (while the remaining players are not active) could not improve the existing situation for him. During the distribution of the strategies player A makes the best decision, baring in mind player B, which also makes the best decision, baring in mind the best possible decision of A. The solution of this equality does not mean, that the best result for all participants is achieved, but a situation is assumed where the players modify their positions against the other participants. Parts of this theory are similar to the political interrelations, which in their pure form are a method for distribution of power with a limited number of contenders and where cooperation is allowed regardless of the previously stated positions (for example breaking fundamental principals on incompatibility in coalitions).

The population of each country is a dynamic mass of people, which regularly change their views and political preferences for various but unclear reasons. During 1997 a large part of the Bulgarian population was supporting the political believes of the right, four years later

more center or liberal, while in 2005 the electorate moved to the left. The parties follow this, probably natural way of thing by changing their programs and claimed policies. Those, who have the possibility, knowledge and historic context to position themselves where the mass of people is concentrated, must win most votes. Such movements must be small since they could be accused as without principals and not really serious in their pre-election promises. The Bulgarian Socialist Party (BSP) is taken as rightist for the small steps it took in that direction, such as the reduction of corporate and personal income tax. It is not clear why. Either really BSP is conducting right principals motivating labor and capital with reduced rates and does not surrender in front of the labor unions, or simply they bring more money in the budget for all sorts of "unforeseen" expenses. Only time would tell if BSP would be brave enough to move to the right by reducing the redistribution the tax revenues of the budget. In such way the party could take up some of the positions of the parties from the right in the next parliamentary elections, which themselves are competing in their pre-election programs for liberalization of the economy. GERB looks like the largest opponent of BSP and a threat causes panic in the highest levels of power and immediate closing of such structures as the Commission of tracking prices. Actually the ruling party is making unsuccessful experiments to carry out left policies as well by preserving the status quo in certain sectors of the economy, which may satisfy certain privileged groups, but is harmful to us all, like health, education, infrastructure and available income.

There is a consensus in society on the political preferences is definitely moving towards the right, because the economy is doing well, incomes are rising, the cost of credit are falling, etc. The rates of change however are not sufficient and the change is the basis for the determination of the ruling party to complete what has been (un)initialized. The positions are being distributed between the players before the local elections, which would reaffirm the foundations of some and shake the positions of others. It is interesting to see if the parties are preparing for us a political cartel of the type “you promises this, you that and than will see”. The compromise between the wide spectrum of opinions is already working on both local municipality level and national level, but it means less convincing and slow management. The electorate would discover that they have limited freedom of choice, when the positions become dangerously close. The political model in Bulgaria is shrinking to one dimension, where not the possible policies but the quality of their execution will become the decisive factor. The parties who will bet just on the party color as a symbol of their policies will not be successful due to the simple reason the electorate is tired from unfulfilled promises. They would loose positions to the other party’s in order to prove themselves as players with vision and members capable of leading a quality management. Thus,

as the Government now is under questioning whether or not they could manage under pressure, the remaining parties will have the chance to show how they could handle the problems on the local level. The sensible policy brings negative regardless of how illogical it sounds. That is such because the dynamics of the environment changes positions, while the layers are adjusting very quickly. Consistency, however, is a symbol of quality, while the popular and impossible to forecast moves speak more about an immature long term policy. This is actually the paradox of the Bulgarian political life, while for the Government the lack of decisiveness is the real problem. The direction and desires of the Bulgarian people have been known for quite some time – fast growth of the real income, improvement of public services and good expectations for the future. That could be achieved by withdrawal of the state from the economy – less but better quality and not impairing regulations on the business, transfer of state and municipal service to the private sector, privatization of the state companies, reduction of the Government administration, etc. In the same manner as the revenues from the corporate tax exceed the targets, the expectations of the electorate of the party which breaks up the cartel of political equality in Bulgaria will be exceeded and will take the unexplored positions on the right.

IME News

On October 3rd 2007, a meeting took place in Sofia with **Mart Laar**, Prime minister of Estonia (1992 - 1994 and 1999 – 2002) currently the economic adviser to the Georgian President



On October 19th 2007, a meeting took place in Sofia with **Simeon Dyankov**, the author of the study “Making Business” of the World Bank.



On October 16th 2007, from 11:00 AM, in the press club of Sofia Press there was a press conference about:

“The demands of the teacher for 100% increase in their wages – effects for the Bulgarian economy and possible solutions”!



On October 26th 2007 in the press club of the BTA the Institute for Market Economics held a press conference about:

“The building permits – clear and accessible in Internet”.



Support IME!

If you are in favour of the free market and economic freedom, you can participate in IME fundraising campaign by making on-line donation via [ePay!](#)

Institute of Market Economics, Bulgaria (www.ime.bg/en)

Krassen Stanchev, Svetla Kostadinova, Dimitar Chobanov, Adriana Mladenova, Veliko Dimitrov, Metodi V. Metodiev, Peter Ganev, Metodi Lazarov

If you want to subscribe to IME Bulletin via e-mail please click [here](#).

For comments and recommendations: ganev@ime.bg

Contacts: Phone/Fax: (++359 2) 952 62 66, 952 35 03